DISSOLVING BUSINESS ENTITIES

AND

CORPORATE HOUSEKEEPING

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This outline should be viewed only as a summary of the law and not as a substitute for tax or legal consultation in a particular case. Your comments and questions are always welcome.

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PART I – DISSOLVING BUSINESS ENTITIES

1. Key Dissolution Concepts

- "**Liquidation**"
  - Business sense – turning assets into cash
  - Tax sense – a process of ending the life of an entity
    - "Liquidating distributions" are made during the liquidation process
    - There can be a "**de facto**" liquidation
- "**Dissolution**"
  - A corporate law term meaning the formal end of the life of an entity
  - No such thing as a "de facto" dissolution
    - Tied to obligation to pay a franchise tax for the privilege of having a corporation, whether or not it is used.

2. Overview of the Dissolution Process

- Board adopts plan of liquidation
- Shareholders approve it – liquidation process starts
- Corporation files Form 966 with IRS
- Corporation pays its debts and makes liquidating distributions to shareholders
- Corporation dissolves and files final tax returns – generally liquidation process ends
- Corporation can be sued for up to four years and can quiet title in real property at any time. The last officers serves as "ghost officers" and the last agent for service of process serves as a "ghost agent for service of process" (these are my own terms).

3. Dissolution and Taxes

3.1. "Inside" tax

– Tax on gain on the corporation's assets deemed sold when distributed to the shareholders

  • Exception: Section 332/337 liquidation of a subsidiary. See Section 3.3 below.

– 💣 Cash method receivables are realized if distributed in liquidation (The 💣 symbol indicates traps for the unwary.)

3.2. "Outside" tax

– Liquidating distributions are taxed as if the shares were sold for a price equal to the value of the distributed assets

  • A shareholders' gain is reduced by his or her basis in the shares; low long-term capital gain rates can apply

    ⇨ If it's really a "liquidation-reincorporation," the distributions are taxable as ordinary divi-

dends and basis is not applied to reduce the amount of the dividend.

- Shareholders take a fair market value basis in the distributed property

– File Form 966 with the IRS to evidence that a plan of liquidation has been adopted by the shareholders and that subsequent distributions will be "liquidating distributions"

– "Open transaction" treatment allows a shareholder to apply all basis to the first gain, if total gain on liquidation is uncertain

- The IRS does not like open transaction treatment, but the courts allow it when no other way of applying share basis to the liquidating distributions makes sense.

3.3. Section 332 Liquidation of a Subsidiary into a Parent

– No outside gain to *corporate* parent in a Section 332 liquidation of a subsidiary

- Corporate parent must own at least 80% of the outstanding stock of the subsidiary.

- *Minority shareholders in the sub **do** recognize gain on their liquidating distributions*

– Carryover basis in the distributed *assets* –

- 💣 *The parent's basis in the subsidiary stock disappears!*

- 💣 Because a QSub election by an S corporation parent is treated as a Section 332 dissolution, *the "outside" basis in the subsidiary's stock disappears in a QSub election, too*.

  ⇨ If the parent recently bought the stock of the subsidiary, and the subsidiary has a low basis

in its assets, consider alternatives to the dissolution.

⇨ If the parent has not yet bought the stock of the target corporation, consider having the shareholders of the parent acquire the target stock. That is, consider a brother-sister structure and not a parent-subsidiary structure. To preserve the basis in the stock.

- The subsidiary's tax attributes (including NOLs) carry over to the parent – in a "good" Section 332 liquidation.

– It is possible to have a liquidation or merger of a 80% or more subsidiary into its parent that *fails to qualify* for Section 332 treatment (a "bad" Section 332 liquidation).

- The liquidation or merger would fail to qualify *if the subsidiary is indebted to the parent for more than the value of the subsidiary's assets*.

- The transfer of assets from the subsidiary to the parent would not be a distribution with respect to the stock, but would be in partial satisfaction of the debt.

- *Gain possible for the subsidiary* if it transfers appreciated assets.

- Parent might have bad debt deduction for unsatisfied debt of subsidiary to parent.

- No carryover basis.

- 💣 All of the subsidiary's tax attributes disappear – *including its NOLs*. See *Preserving NOLs in a Sub-into-Parent Liquidation* below at Section 5.

3.4. S corporations

– Key concept - Outside share basis *increases* for every dollar of inside income or gain – and *decreases* for losses and distributions

– Non-liquidating distributions might be tax-free distribution of S corporation earnings – so defer the liquidation?

  • Not usually. The basis in the shares will reduce the outside gain.

  • But if the "liquidating distributions" would be spread over more than one year, consider deferring adopting a plan of liquidation until the year in which the final distributions are planned.

    ⇨ Otherwise, tax might be paid sooner than necessary.

– 💣 The inside gain can be subject to the "built-in gain" tax

3.5. Installment receivables

– 💣 For C corporations or S corps with built-in gain, *do not liquidate* until the installment obligations are collected to avoid accelerating deferred "*inside"* gain

  • Exception: Section 332 liquidation

  • Exception: S corporation with no built-in gain

– "Outside" gain *can* be deferred when an installment method receivable is distributed to the shareholders

– If tax rates on capital gain increase, the increased rate will apply when the deferred gain is recognized.

3.6. Personal holding company

– Liquidate to *avoid* double tax on forced dividends?

  • Gain recognized sooner, but basis applies to reduce gain

  • Ordinary dividends will be taxed later, but without reduction for basis

- Consider S corporation election – and steps to avoid the *double penalties* for "excess passive receipts.

  ⇨ A corporate-level tax, and

  ⇨ Termination of the S corporation status after three consecutive years with excess passive receipts.

3.7. *Arrowsmith* and capital loss

– Possible scenarios – after the last liquidating distribution to shareholders, they pay:

  - An indemnification claim,
  - A tax assessment against the corporation,
  - A judgment against the corporation, or .
  - A purchase price adjustment.

– 💣 "Inverse" of capital gain on liquidating distribution is capital loss on pay-back by shareholder to (or for) the corporation

  - Capital loss is not very useful
  - No carry back for capital loss
  - Consider instead deferring final liquidating distribution – until the claim is resolved

3.8. Section 1244 stock

– Turns capital loss into more useful ordinary loss

  - Up to $50,000 of loss for a single taxpayer in any year
  - Up to $100,000 for married taxpayers filing jointly

– No need to adopt a "section 1244 plan"

– Do need a formal liquidation

  • Not "de facto" liquidation

  • File Form 966 *before* making liquidating distributions

3.9. California sales tax

– No sales tax on liquidating distributions…

– … Unless:

  • 💣 The shareholders assume debt of the corporation, or

  • 💣 The distributions are not made in proportion to share ownership

– The "occasional sale" rule can apply

3.10. California property tax

– No reassessment if property is distributed in *exact* proportion to share ownership

– 💣 Concern: Step transactions

  • *Share* transfers just *before* the distribution

  • *Property* transfers just *after* the distribution

4. The Zero Tax Liquidation of an S Corporation

Situation: Sole shareholder of S corp dies. Heir wants to sell the asset in the corp. The S corp's asset would create long-term capital gain when sold. S corp has zero basis in its asset.

Tip: Sell the asset and distribute the sale proceeds *in the same year*. There will be no capital gain tax on the sale or distribution. Or just distribute the asset to the shareholder -- no capital gain tax.

Note: Recall that estates of 2010 decedents can choose estate tax with a step up basis or no estate tax and modified carryover basis. If the mod-

ified carryover basis applied, there probably would not be "outside" capital loss to offset the "inside" capital gain in the examples on the next page.

Note: The "outside" capital loss will not offset "inside" ordinary income, such as depreciation recapture.

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4.1. **Zero** tax *sale* **of S corp capital asset**

– Heir gets a basis step-up in stock to FMV – to $100.

– S corp sells *capital asset* for $100 cash

- Inside gain of $100 flows through to heir.

☆ Heir's stock basis jumps from $100 to $200.

– Same year: Heir receives cash in liquidation of S corp.

- Amount realized on distribution = $100 cash
- Basis in stock = $200

☺ $100 *outside* capital *loss* on distribution *offsets* $100 *inside* capital *gain* on sale.

4.2. ***Botched*** **zero tax *sale* of S corp asset**

– *Heir gets a* basis step-up in stock to FMV – to $100.

– S corp sells capital *asset*.

- Inside gain of $100 flows through to heir.
- Heir pays tax on capital gain.
- Heir's stock basis jumps from $100 to $200.

– 💣 *Next year:* Heir receives cash in liquidation of S corp.

- Amount realized on distribution = $100 cash
- Basis in stock = $200

☆ $100 outside capital loss on distribution.

☹ *No* offset. *No* carry back!

4.3. Zero tax *distribution* of S corp asset

– Heir gets a basis step-up in stock to FMV – to $100.

– S corp *distributes* the capital asset.

  • Inside gain of $100 flows through to heir.

  • Heir's stock basis jumps from $100 to $200.

– *Same* year: Heir gets the asset in liquidation of S corp.

  • Amount realized on distribution = $100 FMV

  • Basis in stock = $200

☺ $100 outside capital loss on distribution offsets inside capital gain on distribution.

☺ Can't go wrong with a distribution.

4.4. Planning for a zero tax distribution

– Don't make gifts of the stock

  • 💣 The gifted stock will take a carry-over basis and will *not* get a basis step-up when the decedent's stock gets a basis step-up.

  • So there will be *gain* deemed sale of the gifted stock in the liquidation.

5. Preserving NOLs in a Sub-into-Parent Liquidation

Situation: Parent Corp has pumped cash into its subsidiary but Subsidiary's business failed. *Sub is indebted to Parent for more than Subsidiary's assets are worth*. Sub has lots of unexpired NOLs.

Issue: How to dispose of Sub?

Intuitive: Merge Sub into Parent?

Not so fast…

5.1. How to dispose of an insolvent Sub with NOLs?

– In this situation, the Sub => Parent merger is a *failed Section 332 liquidation*

  • 💣 The NOLs won't survive

– Better: Merge Parent => Sub and re-name Sub with Parent's name

  • This is a good Type A reorg

  • The NOLs *will* survive

6. Dissolutions and Corporate Law

6.1. The Mechanics of Dissolving a California Corporation

– Directors adopt a "plan of liquidation"

– Shareholders approve the plan

  • At least 50% for a voluntary dissolution

    ⇨ Other 50% can buy "dissolver" out for appraised value in cash

  • Or court orders it, when at least 1/3 of the shares ask for it and show good cause

    ⇨ Or any shareholder of a "close corporation"

– Officers must advise **known creditors** that the corporation has adopted a plan of liquidation

  • It is the duty of the officers and directors to assure that creditors are paid before shareholders receive liquidating distributions

  • Officers should do a UCC-1 and lien search

- Chapter 5 limitations on distributions do not apply to liquidating distributions

  ⇨ No need for positive retained earnings after the liquidating distributions

– All known corporate debts must be paid or provided for

  - Consider tax for final year
  - Consider buying "tail" insurance
  - Directors must swear that this has been done

– Certificate of Dissolution

  - When this is filed with the California Secretary of State, the corporation is dissolved
  - 💣 The final tax returns are due 2 full months and 15 days later. For a 2-6-09 dissolution, the due date is 5-15-09. *Not* 3-15-10.

– Tax Clearance Certificate

  - Until September, 2006, a dissolution was conditioned on receiving a Tax Clearance Certificate from the California Franchise Tax Board
  - Since September, 2006 it is not necessary (or possible) to get a Tax Clearance Certificate for a dissolution (or merger) of a California entity.

6.2. Nonprofit Public Benefit Corporations

– The Attorney General must approve the distribution of assets before the Secretary of State will file the Certificate of Dissolution

  - The Attorney General checks to see that the distribution is consistent with the dissolution clause in the articles of incorporation

– For all California nonprofit corporations, it is no longer necessary to get a TCC before filing the Certificate of Dissolution

6.3. The Four-Year Rule

– Claims can be made against the corporation for up to four years after the certificate of dissolution is filed

– Then they are barred

– Creditors of the dissolved corporation can get up to the amount distributed to a shareholder in liquidation – any shareholder

  • There is a right of contribution from the other shareholders

  • Consider buying "tail" insurance before dissolving

– Note the tension between:

  • The four-year rule (*Dissolve now!*) and

  • The *Arrowsmith* tax rule (*Never dissolve!* Never distribute all of the assets, to avoid later capital loss)

  • A balance must be found in each dissolution.

6.4. Liquidating trusts and LLCs

– Possible scenarios:

  • The directors do not want to (or cannot) distribute the assets to the shareholders, but they want the four-year clock to start.

  • One wealthy shareholder with a majority of the shares, who will be the prime target for any claimant against the corp, but would prefer to have some of the liquidating distributions kept in a "pot" to pay claims, as opposed to tracking down the other shareholders to indemnify Mr. Big for the claim he paid.

- Two shareholders (or families), neither wants to have to pay a claim and then seek indemnification from the other.

– It is possible to distribute some of the assets to a trust or LLC, if the shareholders approve it

– The trust or LLC generally dissolves when it sells its assets or, if later, when the four years end

– Trusts were once common, but LLCs are used more after the "check-the-box" regs

6.5. Stock certificates

– When the corporation dissolves, it is a good idea to mark "CANCELLED" across the face of the outstanding stock certificates, collect them and insert them in the stock book.

– Otherwise, an heir might find the certificate and waste time and money looking for the corporation.

6.6. Let the corporation die on the vine? No.

– Too many loose ends

– Too many letters from the Secretary of State and Franchise Tax Board

– Minimum taxes accrue, with interest and penalties

– The corporation cannot defend lawsuits or enforce contracts or protect its name while it is suspended

– Heirs and executors will fret about it

– Better: decide to dissolve and JUST DO IT

7. Dissolving Partnerships

– 💣 Any *negative capital accounts* to pay back at dissolution?

– Filings

  • File Form GP-4 for a general partnership, or Form LP-3 for a limited partnership to dissolve it

    ⇨ 💣 There is no "dying on the vine" for LPs because the GP is liable for all of the minimum tax, interest and penalties

  • If there is a statement of partnership recorded in a county, record the file-stamped GP-4 or LP-3 there, or a notice that the partnership has dissolved

    ⇨ If a Form GP-1 or LP-1 has never been filed for the partnership, it will be necessary to file Form GP-1 or LP-1 before the other forms.

  • If there is a *fictitious business name* filing in effect, file a notice *abandoning* the name

8. Dissolving LLCs, PCs, LLPs and Close Corporations

– For LLCs, the process is similar to a limited partnership, but there is no GP with unlimited liability

– PCs and LLPs must also file with their licensing authorities

– Partnerships and LLCs – read the partnership or operating agreement

– Close corporations – read the shareholders agreement

9. The Merger Alternative

– Rather than *dissolve*, consider *merging* into another entity

  • Easy asset transfer and liability assumption

  • No need to advise creditors (but consider whether the merger is an event of default)

- NOLs can survive (if done right)
- 💣 *No four-year rule to limit liability in a merger*
- 💣 Corporation => partnership or LLC merger (or conversion) is a taxable liquidation of the corporation

10. Keeping the Name

– An unrelated entity cannot be prevented from using the name of the dissolved entity
  - Unless there is another related entity that will survive and should use the corporate name,
  - Also applies to suspended entities

– Customer confusion can be prevented under trademark law
  - The best way to protect the name is a *federal trademark registration*
  - A "*fictitious business name statement*" (or "dba") filing provides much weaker protection

Part II - Corporate Housekeeping

11. Stock Certificates

– Critical record of ownership, like a deed to a home
  - 💣 There is no title insurance for shares of closely-held businesses
  - Advisers and officers worry about "updating the minute book," but updating the stock book can be much more important.
  - The stock certificates are the primary record of ownership, not the percentage interests listed in the Form 1120S (or the Schedules K-1) or the Form 706.

– When a business sells, the buyer's attorneys will review the seller's stock records in the due diligence process

  • They might ask the seller's attorney for a legal opinion that the shares are "duly issued"

  • Sometimes that is tough

– There must be assignments to reflect each transfer

  • A *stock assignment separate from certificate* is best because once the certificate is signed, it is forever

– All of the stock certificates back to the first issuance should be reflected in the *stock book*, in which should be:

  • All of the signed receipt stubs

  • All of the cancelled stock certificates

  • All of the blank stock certificates

– When a stock certificate is lost, the owner of it should sign an *affidavit of lost stock certificate*, which should be placed in the stock book where the certificate would have gone

  • A replacement certificate should be issued immediately

– If there are *gaps* in the stock records, it is best to get *declarations* from everyone living who has ever been an officer or director of the corporation, to state their knowledge of the share history

  • 💣 Without this, it is difficult to opine that all of the current shareholders can be identified

  • The sooner this is done, the better.

  • The declarations should be kept in the minute book, unless those that address a specific certificate, which should be kept in the stock book in that certificate's place

12. Minutes

– The **shareholders** elect the directors

– The **Board of Directors** is charged with supervising the officers of the corporation

– The directors elect the **officers**, who hire the employees

– The officers manage the **day-to-day activities** of the corporation

– Generally, the **Board of Directors** should *meet* at least annually, but seldom more frequently than quarterly

  • **Minutes** of each meeting should be prepared, signed by the corporate secretary and the president, and kept in the minute book

  • **Notices** of the meeting, or written waiver of notice should also be kept in the minute book

    ⇨ Action at the meeting might not be valid if **proper notice** of the meeting is not delivered before the meeting. It is also necessary to have a **quorum** for valid action at a meeting.

  • The corporate secretary should sign an **affidavit of sending notice** and insert it in the minute book, unless all of the directors attend or provide waivers of notice of the meeting

  • Minutes should cover the **election** of officers and the **approval** of major contracts and borrowings

  • Minutes should reflect that the president or CFO **reported** on the corporation's finances and that the president or a VP reported on operations and growth plans

  • Minutes should tread lightly on subjects on which the corporation or the board could be **sued**

  • Each and every **distribution** should be approved by the board, to minimize the risk of **"piercing the corporate veil"**

– Minutes should also be prepared for **shareholders** meetings

  • Generally, the shareholders **elect directors** and not much else …

  • Unless the bylaws or articles are amended, the corporation merges, sells substantially all of its assets or dissolves

  • Shareholders sometimes approve transactions between an officer or director and the corporation, but not compensation arrangements

– It is a good practice to have "outside directors" who are not employees of the business or related to the principal shareholders

  • It is a good practice for the outside directors to sit on a compensation committee to set the compensation packages of the officers

    ⇨ This is now required for publicly held corporations and many nonprofit corporations.

  • Outside directors can be very helpful in a transition from one generation of management to the next

  • Outside directors will appreciate the corporation's directors and officers ("D&O") liability insurance policy, and they are likely to ask about it.

A final thought ...

⇨ Consider working with an attorney who is familiar with these things ... and who can make it easy for you.

[End of outline.]